STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NEW LANDING UTILITY, INC.	)	
	)	
Proposed General Increase	)	Docket No. 04-0610
In Water and Sewer Rates.	)	

INITIAL BRIEF OF

THE PEOPLE OF THE STATE OF ILLINOIS

The People of the State of Illinois

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I. Introduction: The Commission Should Petition The Court To Appoint A Receiver For NLU And Find That NLU's Revenues Currently More Than Cover Its Costs, Excluding A Return On Capital.

The People of the State of Illinois by Lisa Madigan, Attorney General of the State of Illinois ("the People") request that the Commission take two steps in response to the request of New Landing Utility, Inc. ("NLU" or "the Company") for a substantial increase in water and sewer rates.

First, the People maintain that pursuant to Section 4-501 of the Public Utilities Act ("Act"), 220 ILCS 5/4-501, the Commission should petition the Circuit Court to attach the assets of NLU and place NLU under the control and responsibility of a receiver. The lack of responsible management demonstrated by this utility and the substandard service received by its customers demand that the Commission act now to protect the utility and its customers from further mismanagement and dissipation. The current management has demonstrated through the evidence amassed in this docket that it lacks the technical, financial and managerial resources and ability to provide safe, adequate, or reliable service and that it has effectively abandoned part of its service territory by disavowing responsibility for the water distribution lines in the Lost Nation area. Further, the acquisition of the utility by its current owner, who was then the utility's lawyer and is now NLU's President, was never approved by the Commission, calling into question its right to control and manage the utility.

Second, the People's witnesses, along with the Staff of the Commission, have examined the expenses and income of NLU to the extent that they were presented by the utility. Section 9-201(c) of the PUA requires a utility to "establish the justness and reasonableness of the proposed rates or other charges, classifications, contracts, practices,

rules or regulations." 220 ILCS 5/9-201(c). The evidence produced by NLU, in its testimony and exhibits and its responses to the data requests and testimony of other parties, does not provide a basis for establishing new rates for NLU. NLU has utterly failed to meet its burden of proof, and on that basis alone, should be denied any revenue increase.

Using the information NLU did provide, and based on the testimony of David J. Effron, AG Ex. 1, the People request that the Commission deny NLU any rate increase so long as the current management remains in place because current revenues more than cover expenses, and because the Commission should not authorize a company as poorly run as NLU is run to receive a return on investment. Once a receiver is appointed, however, the People expect that the true income and expenses of the utility can be discerned and just and reasonable rates can then be set to accurately reflect expenses and the access to capital that the receiver will have to establish.

II. The Commission Must File a Petition for Receivership to Protect the Ratepayers in NLU's Certificated Service Area.

A. The Record Clearly Demonstrates That NLU Has Failed To Provide Safe, Adequate, and Reliable Service and Has Allowed The Utility's Plant To Deteriorate To An Alarming Extent.

As NLU repeatedly pointed out in its filings, this docket is the first matter that NLU has brought before the Commission in 23 years. NL Ex. 1 at 5. Gene Armstrong became the President of NLU when DAME Co. purchased the company, and he continues to operate the utility. NL Ex. 1 at 1. DAME Co. bought NLU in 1984, and Gene Armstrong is the sole shareholder of DAME Co. NL Ex. 1 at 1. Neither NLU nor DAME Co. requested Commission approval to transfer ownership from NLU's previous owner to DAME Co. AG Ex. 4 at 24.

1. The Water Plant Is Seriously Deteriorated As A Result Of Years Of Neglect.

Since DAME Co. purchased NLU, the conditions at NLU have deteriorated to an alarming extent. Although Mr. Armstrong acknowledged that water towers should be painted every 10-12 years, Tr. 356, NLU's water tower has not been painted "in at least thirty years." NL Ex. 1 at 6. Mr. Armstrong admits that the tower needs extensive work, and the evidence plainly shows that the tower and the tank support are very rusty and "seriously corroded." AG Ex. 4.1 at 3. Photos showing the deplorable condition of the tank and the water plant are attached to AG Ex. 4.1 at Sch. SJR-9.

NLU's drinking water distribution system is also in an advanced state of disrepair. Out of the 309 active water customers, 101 customers cannot receive metered water service because the water contains "sediments that constantly jam water meters." AG Ex. 4 at 10, quoting NLU Response to Staff Data Request CLH-2. Customers complain of rock, sand, and sediment in their water lines, damage to appliances, very low water pressure, clogged fixtures, and cloudy and dirty water. AG Ex. 4 at 9-10. Customers testified to these problems in January of 2004, and NLU and the Lost Nation Property Owners Association stipulated at trial that these problems continued to exist as of the date of trial (April 5, 2005). Tr. 527; AG Ex. 4, Sch. SJR-3, January 6, 7, and 9, 2004.

The Commission's Water Department has also noted the deficiencies in NLU's water plant. After several Commission representatives inspected NLU's plant on May 24, 2004, the Manager of the Commission's Water Department sent NLU a letter identifying 23 deficiencies in its water and sewer operations. AG Ex. 4, Sch. SJR-4. The drinking water problems identified by the Water Department include: the failure to

maintain records; failure to inspect and test water meters; failure to vent the chlorine tank; failure to properly maintain facilities, including the water tower; failure to flush water lines; and failure to have a backup source of water. Id.

Many of the water service problems identified by the ICC Water Department had been brought to NLU's attention by Mr. Hanson of the IEPA for more than twenty years, beginning in about 1980. AG Ex. 2 at 5-6. Mr. Hanson described his efforts to bring eight items identified in the ICC letter to NLU's attention over the years. AG Ex. 2 at 4-14. The three deficiencies that the Water Department identified that related to the water tower (install an adequate overflow pipe (item d), properly fence and protect water tower (item e), repaint water tower to prevent further deterioration (item f)), were the subject of the IEPA's enforcement action which resulted in a September 28, 2004 Order finding NLU in violation of the law and directing NLU to take action. AG Ex. 2 at 6-7; AG Ex. 4, Sch. SJR-2 at 6-7. Although NLU submitted a contract to the Commission to repair and repaint the water tower, as of the hearing on April 4, 2005, no work had begun. Tr. at 359.

The enforcement action also addressed the need to seal abandoned wells (item b) and to install flushing hydrants (item g). Mr. Hanson testified that the other items identified in the Water Department's letter, such as the need to replace undersized mains (item j), the need to loop the distribution system along Flagg Road (item i) and the removal of the 4 inch main over the spillway (item h) had been addressed in IEPA correspondence with NLU, and should be implemented to improve reliability. AG Ex. 2 at 10-14.

After years of litigation against the IEPA, which sought to compel compliance with drinking water safety and environmental regulations, judgment was entered against NLU and it was ordered to properly seal abandoned wells, install flushing hydrants, and adopt a cross-connect program to prevent contamination of the water supply from back-flow or as a result of low pressure. See AG Ex. 4, Sch. SJR-2 at ¶ 6-7 (abandoned wells); ¶8 (cross connect program); ¶ 13 (flushing hydrants). The wells have been sealed and the flushing hydrants installed, although the surface restoration work was not completed and some leaks still needed to be eliminated at the time of the hearing. Tr. at 619, 621. NLU was also ordered to complete the work on the water tower within six months of the Order, or by March 28, 2005. AG Ex.4, Sch. SJR-2 at ¶18. No work had started on the water tower as of the April 4, 2005 hearing. Tr. at 359.

2. The Sewer Plant Has Not Been Maintained, Is Barely Operable, Produces A Strong, Foul Odor, And Its Effluent Levels Exceed State Standards.

Mr. Armstrong admits that NLU's sewer plant "is the other pressing renovation project," that its aeration system and backup generator need to be replaced, and that it emits a foul odor. NL Ex. 1 at 6 & Tr. at 338. In addition, AG witness Scott Rubin visited the sewer plant on late March, 2005. He described it as emitting a very strong, foul odor; operated by makeshift pipes and hoses; that its treatment systems were being bypassed; and that the discharge failed to meet nearly every requirement of its wastewater permit. AG Ex. 4.1 at 4-5. Photos showing hoses and pipes running along the floor and rusty equipment are attached to AG Ex. 4.1 at Sch. SJR-10.

The Commission's Water Department also identified deficiencies in NLU's sewer plant. Its June 15, 2005 and August 5, 2005 inspection letters recommended that sludge

be removed regularly, that there be a working standby generator, and that the aeration system be brought into compliance with effluent limits. AG Ex. 3, Sch. 1. These are the same problems that the IEPA has been bringing to NLU's attention for many years. See generally AG Ex. 2. Yet, to date none of these problems have been resolved, notwithstanding the relatively low cost to remedy many of them. See AG Ex. 2, Sch. 3 at last page & Sch. 4 at last page.

AG witness Dennis Connor, the IEPA inspector who has monitored NLU's waste-water plant for more than twelve years, identified numerous deficiencies in NLU's plant. He testified that: "Operation and maintenance conditions at this plant were unsatisfactory at the time of the most recent visits. Many of the mechanical units, particularly most of the pumps, two of the blowers, the polymer addition system, flow meter and standby generator were out of service. Aeration was inadequate in the process aeration tank. **Needed repairs were not performed and preventative maintenance appeared to be nonexistent**." AG Ex. 3 at 4 (bold added). His testimony shows that the permit to transport excess sludge expired on December 26, 2001, and that sludge had not been removed since about 1998. See AG Ex. 3 at 4; AG Ex. 3, Sch. 3 at 6 (June 18, 2004 report); AG Ex. 3, Sch. 4 at 6, 8 (Oct. 1, 2002 report). He also testified that NLU reported "chronic excursions, or variations from requirements, of every parameter reported on the Discharge Monitoring Reports…. These excursions occurred on nearly every Discharge Monitoring Report over the past several years." AG Ex. 3 at 5.

3. NLU's Response To Regulatory Efforts To Bring Its Systems Into Compliance Has Been To Spend Money On Attorneys To Fight Rather Than To Spend Money To Comply, Even When Customers' Health and Safety Is At Risk.

Regulatory efforts to bring NLU's plant into compliance with state environmental laws culminated in an enforcement action focusing on the drinking water plant. In an action entitled People of the State of Illinois v. New Landing Utility, Inc., Gene Armstrong, 00 CH 97 (Ogle County Circuit Court), the IEPA brought a fifteen count complaint against NLU related to its drinking water operations. Seven of those counts were resolved by summary judgment for the IEPA, and the remaining eight counts were also resolved in favor of the IEPA by Order dated September 28, 2004. AG Ex. 4, Sch. SJR-2.

Mr. Armstrong stated that that cost to defend the suit are "staggering, to say the least" and that "legal fees are almost certain to exceed $250,000." NL Ex. 1 at 6, 7. The data request responses prepared by NLU indicated that from 2001 through 2003, NLU spent $390,000 on legal fees. AG Ex. 4 at 12. On cross-examination Mr. Armstrong said he would not be surprised if NLU owned him up to $200,000 in attorney's fees. Tr. at 436. By contrast, Mr. Armstrong estimated the cost to repair the water tower, which was a major issue in the enforcement action, to be $250,000 to $300,000, about the same amount NLU incurred in attorney's fees. NL Ex. 1 at 6. The other deficiencies cited in the action and have basically been remedied. AG Ex. 2 at 8, 9. (flushing hydrants, sealing abandoned wells).

The many deficiencies cited in the Water Department's letters, the IEPA correspondence showing a twenty year effort to get NLU to comply with regulatory requirements, and incurring a "staggering" amount of attorney's fees to defend the IEPA suit rather than spend the money on repair, show skewed priorities and a disturbing pattern of disregard for the health and safety of NLU's drinking water customers.

In addition, for more than seven years (January 1, 1994 through May 1, 2001), NLU did not have a certified water operator despite the fact that a water operator is required to maintain facilities and administer chemicals to the water, and Mr. Armstrong admitted that he relies on the certified operator to insure that NLU's plant functions. AG Ex. 4 at 19 & Sch. SJR-2 at ¶4; NL ex. 1 at 3. IEPA records also show that the IEPA was concerned that NLU did not have a sewer operator in 1988, 1997 and 2001. AG Ex. 3 at 10-11. Mr. Armstrong has no experience in operating a sewer treatment plant, and must rely on certified operators. Tr. at 333.

Finally, while this case was pending, NLU fell behind in payments to the water operator, resulting in a five month, $2,500 arrearage. AG Cross Ex. 4. When NLU bounced two checks sent to the water operator, the operator notified NLU that he would resign effective April 11, 2005. People's Motion to Supplement the Record, Ex. 1. NLU customers are again at risk of taking water from a system that lacks a certified water operator.

B. The Commission Must Petition The Circuit Court For The Appointment Of A Receiver Because NLU Is Not Fit To Provide Safe, Adequate, and Reliable Service.

The service provided by NLU and the condition of its plant demonstrate that NLU's practices are not just and reasonable and do not met its obligations to provide safe, adequate and reliable service. See 220 ILCS 5/9-201(c) and 220 ILCS 5/4-501. The Public Utilities Act authorizes the Commission to petition the Circuit Court to place a public utility under the control of a receiver when the public is at risk and the utility falls within *any one* of the following conditions. The utility:

(1) is unable or unwilling to provide safe, adequate, or reliable service;

(2) no longer possesses sufficient technical, financial, or managerial resources and abilities to provide safe, adequate, or reliable service;

(3) has been actually or effectively abandoned by its owners or operators;

(4) has defaulted on a bond, note, or loan issued or guaranteed by a department, office, commission, board, authority, or other unit of State government;

(5) has failed to comply, within a reasonable period of time, with an order of the Commission concerning the safety, adequacy, efficiency, or reasonableness of service; or

(6) has allowed property owned or controlled by it to be used in violation of a final order of the Commission.

220 ILCS 5/4-501. The evidence adduced in this case demonstrates that NLU meets at least four of these elements and a receiver is required.

1. NLU is unable or unwilling to provide safe, adequate, or reliable service.

As demonstrated above, the drinking water that NLU provides to many of its customers is of poor quality. The water of fully one third of its water customers is so filled with sediment that the water meters clog repeatedly and cannot be used. The water is of such poor quality that it damages appliances such as hot water tanks, dishwashers and faucets. There have been boil orders, "repeated bouts of very low water pressure," and dirty and cloudy water. AG Ex. 4 at 9. NLU has operated without a certified water operator in the past, and its current operator recently resigned due to payment difficulties. Referring to the last time NLU operated without a certified operator, AG witness Mr. Rubin stated: "Failure to have a certified operator jeopardized the public health and safety, threatened the health of NLU's customers, and endangered the value of NLU's physical assets." AG Ex. 4 at 20. NLU customers are once again facing the prospect of no certified water operator.

NLU has refused to take action to insure that its water supply is reliable. The water tower is in very poor condition, and failed in February, 2004, when it developed a leak that took five days to repair, and necessitated a 3 day boil order. NL Ex. 1 at 7 & Tr. 351. Yet, no preventative maintenance was done on the tower either before or after the leak, notwithstanding years of IEPA correspondence to maintain the tower, and Mr. Armstrong's understanding that the outside of water towers should be painted every 7 years and the inside every 14 years. Tr. at 356. In addition, after NLU installed flushing hydrants on court order, it failed to restore the surrounding area and some leaks persisted. Tr. at 619, 621.

The IEPA and the ICC's Water Department have both identified improvements to the distribution system to improve reliability, including looping a water main to provide service to both sides of the lake; removing a temporary main over a spillway that was installed to provide water when a main broke several years ago; and replacing under-sized distribution mains to improve service quality. AG Ex. 2; AG Ex. 4, Sch. SJR-4 (Water Department letters). The IEPA attempted to work with NLU for over 20 years to motivate the utility to take these actions, but NLU resists making improvements.

As discussed above, the sewer plant is also in a state is disrepair. It emits a foul ordor, much of the equipment is inoperable, and make-shift pipe and wires keep the plant operating. Two blowers, the polymer addition system, the flow meter and the standby generator are out of service. Aeration is inadequate and effluent levels have not been within required EPA limits for years. AG Ex. 3 at 4. This is not adequate or reliable sewer service.

NLU's failure to provide safe, adequate and reliable service cannot be explained by lack of money. Like all privately owned utilities in Illinois, NLU can seek an increase in rates by filing tariffs with the Commission, which might or might not suspend them. See 220 ILCS 5/9-201. Yet, close to 20 years elapsed between the time the current management took over NLU and its first rate request.[1]

NLU has failed to invest the resources it has in its operations. As shown on Schedule SJR-6, AG Ex. 4, NLU's depreciation expense is $19,925. Depreciation, which is an expense but not a cash outlay, provides a source of funding for capital improvements. Yet, NLU reported no investment in its plant since 1993, as demonstrated by the $200,000 decrease in net plant in service from 1993 to 2003. AG Ex. 4 at 14. Further, NLU reported $310,844 in payments to either the owner (Gene Armstrong) or his family during the years 2000 through 2003. This does not include the remaining attorney's fees due for 2004 and 2005. When owner payments and depreciation are netted against the losses NLU reported in its Annual Reports to the Commission for the years 2000 through 2003, it is clear that NLU had at least $83,342 over that time to invest in its operations. AG Ex. 4, Sch. SJR-6. NLU should not be excused for not providing safe, adequate and reliable service due to lack of revenues.

2. NLU No Longer Possesses Sufficient Technical, Financial, Or Managerial Resources And Abilities To Provide Safe, Adequate, Or Reliable Service.

a. NLU Lacks Sufficient Technical Resources and Abilities To Provide Adequate Service.

The President of NLU is Gene Armstrong. He is also the sole shareholder of the owner of NLU, DAME Co. There are no other NLU employees. NL Ex. 1 at 1. The

[1] NLU requested a rate increase using the Commission's "short form procedures" in May, 2003. However,

Court in People v. NLU provided a cogent analysis of the relationship between NLU and Gene Armstrong:

> "The evidence establishes clearly that, although several layers of insulation exist between NLU and Gene Armstrong, for all practical purposes Armstrong is NLU and NLU is Armstrong. NLU has no employees. The corporation that owns NLU (Dame Co.) is solely owned by Armstrong. Armstrong makes all the critical decisions in regard to the operation of the utility and all payments funnel through him. Armstrong decides who is contracted to work for NLU, what their rate of compensation will be, when and in what manner improvements will be made if made at all, almost exclusively deals with EPA in regard to compliance issues, and determines when and to what extent ICC rate hikes are requested."

AG Ex. 4, Sch. SJR-2 at 8-9. The evidence in this case supports the same conclusions here. In evaluating whether NLU possesses sufficient technical, financial and managerial resources and abilities to provide safe, adequate and reliable service, the only person the Commission must consider is Gene Armstrong.

In assessing NLU's technical fitness, the Commission should first note that NLU was operated for more than seven years without a certified water operator, and that its most recent operator resigned effective April 11, 2005. Mr. Armstrong admits that he "is not involved in the operation of the water system or the sewer system. [He] is not certified." NL Ex. 1 at 3. Mr. Armstrong testified that "As President of NLU, I make arrangements for those certified operators to provide services to NLU." Yet, Mr. Armstrong did not pay the most recent water operator for five months, and when he sent him a check for payment, the check was returned for insufficient funds. The full amount was later wired to the operator. Nevertheless, the operator resigned.

Mr. Armstrong does not know how to operate the water plant. Yet, he was delinquent in paying the certified water operator $500 per month, and lost the operator as

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it withdrew that filing due to anticipated customer opposition and possible delays. NL Ex. 1 at 19.

a result. Without a certified operator, NLU lacks the technical ability to lawfully operate its water system.

Further evidence of lack of technical ability is the decrepit condition of the water plant. Although Mr. Armstrong knows that water towers should be painted every 7 and 14 years, Tr. at 356, he has allowed the NLU water tower to go for 30 years without painting or maintenance. NL Ex. 1 at 6. As a result, the tower is rusty and seriously corroded, the supports are rusty, and access is not properly secured. AG Ex. 4.1 & Sch. SJR-9. The tower leaked in February, 2004, and it took at least five days to repair. NL Ex. 1 at 7 & Tr. at 350-351.

NLU also relies on certified operators to run its sewer plant. Tr. at 333. Yet, the IEPA contacted NLU about the lack of a certified sewer operator in 1988, 1997 and 2001. AG Ex. 3 at 10-11. Further, a utility – not the operator -- is ordinarily responsible for funding replacement or repair of equipment. Tr. at 640. IEPA concerns about the lack of a certified operator in the past, combined with the persistent effluent violations and the broken-down condition of the sewer plant demonstrate that Mr. Armstrong has not exercised sufficient technical knowledge and ability to properly maintain and operate the sewer plant.

b. The Evidence Demonstrates That NLU Lacks Sufficient Financial Ability and Resources To Provide Adequate Service.

NLU has claims that it cannot repair its water and its sewer plant because it lacks the funds to do so. However, the record demonstrates that NLU has failed to maintain access to capital to enable it to obtain either investor funds or a loan to cover necessary expenses. In Staff Cross Exhibits 3 and 4, NLU states that the "utility believes that no

informed investor would be willing to provide new equity capital" and "no informed lender would be willing to provide new debt capital." Mr. Armstrong claims that "There has never been a year in which NLU has realized a profit; we have always suffered losses." NL Ex. 1 at 13. Yet, despite the fact that Mr. Armstrong considers himself knowledgeable in public utilities law, and that he represented NLU in its first rate case, Tr. at 269, and presumably represented other utilities in connection with rate requests, Mr. Armstrong never brought a rate case on behalf of NLU to insure that it had adequate resources to cover its expenses and maintain its access to capital.

NLU's balance sheet shows that for the past 20 years it has sustained losses, but it failed to seek a rate increase until 2003 at the earliest. AG Ex. 4 at 21; NL Ex. 1 at 19. Assuming that the balance sheets accurately portray the utility's costs,[2] NLU has been grossly negligent in allowing the utility to lose money to the extent Mr. Armstrong claims ($1,285,289) during the course of DAME Co.'s ownership and Mr. Armstrong's management. NLU's current financial condition demonstrates that the existing management lacks the financial ability and has lost the financial resources necessary to provide safe, adequate and reliable service.

c. The Evidence Demonstrates That NLU Lacks Sufficient Managerial Ability and Resources To Provide Adequate Service.

[2] At the hearing Mr. Armstrong admitted that he has never used an accountant for NLU's Annual Report, and testified that he was entitled to $550 per month under the Management Services Agreement that he claims AMI transferred to DAME Co. However, his income statement lists the amount due under the Management Services Agreement to be $14,000 per year, considerably more than the amount he testified was accrued. In explanation, Mr. Armstrong said: I thought it was time for a raise." Tr. 288-289, 381-382. He also claims that he receives no compensation for his work at NLU, calling into question whether the amounts identified as accrued under the Management Services Agreement are legitimate, real expenses. See NL Ex. 1 at 1.

Mr. Armstrong has run NLU since June, 1984 when DAME Co. purchased NLU. He is involved in all aspects of the business side of NLU. NL Ex. At 3. He decides when bills are paid, and what investments are affordable and are made. Tr. at 324-325. He is the sole person who provides services under the Management Services Agreement that he claims was transferred to DAME Co. from AMI, the former owners. NL Ex. 1 at 3; Tr. at 277. He provides accounting services to the utility, although his accounting training is limited to undergraduate courses in the early 1960's. Tr. at 278. He is not an engineer nor certificated as a water or sewer operator. Tr. at 278, NL Ex. 1 at 3. He does not know all of the responsibilities of the water operator and is not experienced in the operation of the sewer treatment plant. Tr. at 294 & 333. He decides what independent contractors will be retained for NLU. NL Ex. 1 at 3. As an attorney, he provides legal services to the utility. NL Ex. 1 at 2.

Managerial fitness includes the overall operation of the utility, including planning, customer service, interface with regulators, oversight of contractors and compliance with applicable laws and regulations. AG Ex. 4 at 17-18. As previously demonstrated, the utility's overall service quality, operation, and condition are dismal. Clearly, Mr. Armstrong, the President responsible for the management of the utility, does not possess the necessary managerial ability or resources to operate NLU. The following illustrate the deficiencies in NLU's management:

1. Although the President is also an attorney and represented the utility before and after he became President, the utility did not seek Commission approval when its ownership and control was transferred to DAME Co. AG Ex. 4 at 23-24.

2. Although the President is also an attorney and represents the utility, the utility has paid the President attorney's fees, paid rental fees to a company in which the President owns a 2/3 interest, and paid fees to DAME Co., as well as fees to the President's wife and son totaling $310,844 over the four years spanning 2000 through 2003. AG Ex. 4, Sch. SJR-6; AG Cross Ex. 3, 5, 6. NLU did not seek Commission approval of any of these contracts until the Commission Staff brought the matter to NLU's attention in connection with ICC Docket 04-0321. It has sought approval of the rental fees and the attorney's fees in ICC Docket 04-0666.
3. When faced with years of IEPA notices of deficiencies, NLU management spent as much money on attorney's fees to fight the IEPA as it would have cost to repair the water tower – the major expense item that was subject to litigation. This delayed the repair to the water tower and was an imprudent use of utility funds. This is particularly questionable in that the President was also an attorney receiving attorney's fees to defend the IEPA suit and NLU also incurred up to $200,000 in attorneys fees payable to its President to defend an IEPA suit. Tr. at 436.
4. The utility has operated for various periods of time without a certified water operator and without a certified sewer operator.
5. The water tower and the sewer plant are in an advanced state of disrepair. The water tower leaked in February, 2004, but other than

emergency repairs, no repair or maintenance work had been done on it as of April 4, 2005 notwithstanding a Court order that the repair work was to be completed by March 28, 2005. Tr. at 359. In connection with the sewer plant, the IEPA sewer inspector noted that "needed repairs were not performed and preventative maintenance appeared to be nonexistent." AG Ex. 3 at 4 & Sch. 3 at 9 (June 18, 2004); Sch. 4 at 7 (Oct. 1, 2002). The permit to remove sludge expired on December 26, 2001, and sludge has not been removed for seven years. AG Ex. 3, Sch. 3 at 6-7. The sewer plant has a strong, foul odor. AG Ex. 3.1.

6. Water quality is poor. Customers complain of sediment in the lines, damaged appliances and cloudy and discolored water. AG Ex. 4 at 9-10 and Sch. SJR-3. NLU stipulated that the problems identified by customers in AG Ex. 4, Sch. SJR-3 are unchanged as of April 5, 2005. Tr. at 527.
7. Out of 309 active water customers, 101 have meters that constantly jam with sediment. As a result, the meters are not used and customers are billed based on company estimated usage. AG Ex 4 at 10.

These are not all of the problems revealed in the record. However, they demonstrate that the current management lacks sufficient ability or resources to provide safe, adequate and reliable service, and that the Commission should seek a receiver to return the utility to acceptable operation.

3. Although NLU Collects Payment From Lost Nation Residents, NLU Has Actually Or Effectively Abandoned That Portion Of Its Service Area, And Has Failed To Comply, Within A Reasonable Period Of Time, With The Commission's Order For Public Convenience And Necessity By Disavowing Responsibility For The Lost Nation Water Service.

On November 14, 1973, the Commission issued a Certificate of Public Convenience and Necessity to NLU and ordered it to provide for:

> the construction, operation and maintenance of a public water supply and distribution system…within the New Landing for the Delta Queen development.

AG Ex. 4 at 15 and Sch. SJR-8 at 4. The Commission Order specifically describes the Lost Nation portion of the development as within the boundaries outlined by the Certificate. Id. at 2-3.

Despite the 1973 Commission Order, Armstrong has denied responsibility for upgrading facilities in the Lost Nation portion of the development. AG Ex. 4 at 14. In response to AG data request 2.10, NLU stated that: "NLU disavows any obligation to maintain these water lines." AG Cross Ex. 9. NLU maintained in the People v. NLU case that it did not own the lines, and therefore could not be required to seal abandoned wells associated with them. NL Ex. 1 at 7 & AG Ex. 4, Sch. SJR-2 at 4. However, the Court found that "As operator of a PWS [Public Water Supply] NLU has a responsibility for water sources connected to it for the benefit of the users of the system. … NLU is responsible to assure the safety of its entire system, which now includes the abandoned wells. This responsibility accrues regardless of whether the means used to include the Lost Nation lines in the PWS was voluntary or involuntary (i.e. by court order)." Id. at 4-5. In this docket NLU continues to maintain that it is not responsible for the Lost Nation lines and the dismal water service and on cross examination gave a long, convoluted

explanation about why he has no responsibility for them. See Tr. 406-413. Essentially, Mr. Armstrong argues that, although NLU has rights to the utility easements, it does not own the lines, which are, in his opinion, still owned by a developer. Tr. 412. Therefore, NLU apparently believes it is not required to maintain the lines or to replace them.

Mr. Armstrong acknowledged that the Lost Nation area is within NLU's certificated service area. Tr. at 415. Under the Certificate, only NLU can offer water service in this area. Yet, NLU refuses to accept responsibility to maintain the Lost Nation water lines despite the Commission's Certificate of Public Convenience and Necessity and a court order directing that NLU connect those lines to its system and reimburse the Lost Nation Property Owners Association for the associated costs. Tr. 433-434.

NLU's refusal to accept responsibility for the Lost Nation lines has driven its response to the IEPA requests that it comply with certain regulatory requirements. NL Ex. 1 at 11 (NLU would not comply with IEPA demands because of NLU's position that it was not responsible for the Lost Nation lines). The IEPA suit requested that NLU seal abandoned wells and install flushing hydrants in the Lost Nation area, which NLU argued it should not be required to do. AG Ex. 4, Sch. SJR-2, ¶7, 13. The Court rejected NLU's position that it was not responsible for any water distribution in the Lost Nation area and ordered NLU to seal the abandoned wells and install flushing hydrants in the Lost Nation area. Id. The Court specifically rejected NLU's argument that it was not responsible for the Lost Nation lines. AG Ex. 4, Sch. SJR-2 at ¶7.

NLU seeks to charge the customers in the Lost Nation area $75.00 per month to fund new water lines. NL Ex. 1 at 10. Ordinarily a privately held utility obtains capital

for capital improvements, invests the money in the utility plant, and receives a return for the cost of capital in its rates. AG Ex. 4 at 21; Tr. at 462-463. NLU, by contrast, has lost its access to capital, and now seeks to force its customers to be investors in its operations. AG Ex. 4 at 12, 21. It is unclear who would own this plant if NLU's plan were adopted.

NLU bills Lost Nation customers and receives payment for the water consumed in that area. Nevertheless, it has "disavowed" its obligation to care for the system that delivers that water. A receiver is necessary to protect the Lost Nation residents who have no option for their water service. By refusing to provide safe, adequate and reliable service to the Lost Nation area, NLU, under current management, has effectively abandoned that service area and the Commission should seek a receiver to protect NLU's ratepayers from paying a company for service that it does not provide.

4. Conclusion: The Commission Should Petition The Circuit Court To Appoint A Receiver For NLU To Protect The Utility From Further Deterioration And To Insure That Its Customers Receive Safe, Adequate And Reliable Service.

This case was opened by the Commission to investigate whether NLU should receive an increase in its revenues. As part of that investigation, the Commission must determine whether NLU's "contracts, practices, rules or regulations" are just and reasonable. 220 ILCS 9/201(c). In reviewing the evidence presented by the utility, it became clear that NLU is a distressed company and that Illinois residents are being exposed to poor water quality and that the rates they pay are not being used to maintain NLU's water and sewer system. As a result, both the Office of the Attorney General and the Staff of the Commission have requested that the Commission ask the Circuit Court to appoint a receiver.

This case requires the Commission to use the statutory power the General Assembly has given it to protect Illinois ratepayers from private parties who abuse their exclusive franchise to provide utility services. Water service is the most basic necessity, and the Commission should take action to insure that customers receiving water from a private utility receive safe, adequate and reliable service. Unfortunately, in NLU's case, the current owner and President have proved unable to comply with their obligations and provide this basic level of service.

In accordance with section 4-501(c), the Staff has identified a party "knowledgeable in the operation of the type of public utility … that is the subject of the petition for receivership." 220 ILCS 5/4-501(c). Staff's Supplement to Motion Requesting The Illinois Commerce Commission to Authorize the Filing of a Petition in the Illinois Circuit Court to Seek the Appointment of a Receiver and to Order the Company to Desist from Making Payments, filed April 1, 2005. The identity of a party willing to become a receiver should give the Commission comfort that NLU will be brought into compliance with the law and that its customers can be assured of safe, adequate and reliable service.

III. NLU's Revenues Currently Cover All Expenses Except a Return on Capital, and Need Not Be Changed.

This is an unusual case. In its first rate case since 1979, NLU requested a 244% increase in water and sewer revenues. AG Ex. 4 at 5. NLU also requested that certain customers pay $75 per month toward a special capital fund, and that other rates be tripled. NLU Ex. 1 at 9-10. NLU presented one witness, its owner[3] and President Gene Armstrong. NLU Ex. 1 and 2. Mr. Armstrong is a practicing attorney. NLU Ex. 1 at 2.

His accounting background is limited to undergraduate courses in the early 1960s. His financial background consists solely of an economics degree received in 1964. Tr. at 278. He is not an engineer. See id. Yet, he sponsored all of the testimony and exhibits that NLU presented to the Commission in support of NLU's request for this huge rate increase.

Mr. David Effron, a regulatory accountant with substantial experience with Illinois utility rate filings, reviewed NLU's filing and responses to data requests. AG Ex. 1 at 1-2. He testified that the "Company did not present the determination of its revenue deficiency in a traditional format." AG Ex. 1 at 4. Mr. Effron assembled a revenue requirement for the Company with the information the Company provided in testimony, exhibits, and responses to data requests, and concluded that NLU's revenues covered its reasonable cost of service. AG Ex. 1 at 6.

In fact, Mr. Effron testified that NLU presently has a revenue excess of $10,243. See id. Mr. Effron arrived at this number by subtracting the return on rate base from his calculation of the Company's revenue requirement and then subtracting that number from annual tariff services plus miscellaneous revenue. See id. As demonstrated above, NLU provides substandard service and its plant is in terrible disrepair. As a result, the Commission should not authorize a return on rate base for NLU.

Staff witness Thomas Griffin also provides the Commission with the option of determining NLU's revenue requirement based upon a 0% return on rate base. ICC Staff Ex. 10.0, Schedules 10.01-W and 10.01-S. Staff offers this option to account for the evidence in this record showing the abuse of discretion by NLU's current management

[3] Mr. Armstrong does not own NLU directly. However, he is the sole shareholder of DAME Co. which is the sole owner of NLU. NLU Ex. 1 at 1.

and NLU's failure to provide safe and reliable service to its customers. See ICC Staff Ex. 11.0 at 8.

Based upon the People's analysis of NLU's revenue requirement, the Commission should find that NLU should not receive a return on rate base under current ownership. Based upon NLU's data, it currently operates with a revenue excess. Additionally, the Commission should order that NLU's revenue excess should be invested into court-ordered improvements, to fund the repair and painting of the water tower. Despite a September 28, 2004 Order to repair the water tower in six months, Mr. Armstrong testified that improvements to the water tower had not yet begun[4]. See Tr. at 359. This condition should be placed on the utility while the Commission's petition to appoint a receiver is pending.

A. If the Commission Allows A Return On Rate Base In NLU's Revenue Requirement, The Return on Rate Base and Cost of Capital Should Be No More Than That Proposed By Mr. Effron.

In the event that the Commission believes a return on rate base can be justified for this utility, the Commission should find that the Company's overall rate of return should be no more than 7.60%. See AG Ex. 1.0 at 13 and Schedule DJE-5. The Commission should reject the Company's requested rate of return because it is unclear how its proposed rate of return relates to its cost of capital. See id at 12. It is also unclear how NLU incorporated the 10.3% rate of return into the Company's cost of service. See id. Based upon Mr. Armstrong's failure to specify a capital structure or present the cost of debt NLU has incurred, the Commission should reject the Company's proposed rate of

[4] In fact, Mr. Armstrong suggested testimony that the water tower was in good condition. See NL Ex. 1 at 6, and Tr. at 352.

return and accept the People's calculation of 7.6%, which was based upon a hypothetical capital structure appropriate for a water utility and a return on equity of 10%. See id.

The Commission should also reject Staff's overall cost of capital of 8.38%. See Staff Ex. 3.0, Schedule 3.01. Using well-established cost of capital analyses, Staff derived a 10.53% return on equity for the water sample and an 8.78% return on equity for the utility sample based on the DCF analysis. Staff Ex. 3.0 at 9, Sch. 3.05. Staff derived a 9.62% return on equity for its water sample and a 10.66% for its utility sample using its risk premium analysis. Staff Ex. 3.0, Sch. 3.06. The result of Staff's DCF and CAPM risk premium analyses, a 9.90% return on equity, is actually slightly lower than Mr. Effron's assumed 10% return on equity. See Staff Ex. 3.0 at 22.

However, with no citation of Illinois precedent, and relying only on her "judgment," Staff witness Phipps added 246 basis points as a liquidity premium to increase the proposed return on equity to 12.35%. See id at 21-22; Tr. at 491. Ms. Phipps testified that she added the liquidity premium to compensate investors for the additional risk that exists when a company is not publicly traded. See Tr. at 493. However, she did not balance against that risk the increased control that an investor that wholly owns the company would have. See id.

Additionally, Ms. Phipps testified that in calculating the liquidity premium, she used the Rural Telephone Finance Cooperative's ("RTFC") rate as a proxy for small utility companies. Staff Ex. 3.0 at 24. Ms. Phipps failed to examine what loans were available to *water* cooperatives or small *water* utilities. Tr. at 496. She also admitted that she normally would not use the cost of capital for a telecommunications company for a water utility like she did in this case. Id at 496. She acknowledged that the

telecommunications industry faced different risks than the water industry and that she did not know what effect these differences may have on the cost of capital. See id at 496-497. Finally, Ms. Phipps testified that she did not know the impact the state of telecommunications has on the RTFC rate because it was not "directly measurable." Id. at 500.

Staff's proposed liquidity premium should be rejected because it is not based on a comparable sample. Given the differences between the telecommunications industry and water utilities, Ms. Phipps does not provide an adequate or reasonable basis for increasing NLU's cost of capital from 9.90% to 12.36%. Her use of a telecommunications sample was erroneous because the risks facing telecommunications carriers, large and small, are qualitatively and quantitatively different from those facing the water industry. Use of that sample results in an unwarranted increase in her proposed cost of capital See Staff Ex. 3.0 at 22.

After removing Ms. Phipps' proposed liquidity premium from her calculation of cost of capital, Staff's proposed cost of capital closely resembles the cost of capital proposed by the People's witness, Mr. Effron. Notwithstanding that Mr. Effron is not a cost of capital expert, the Commission nonetheless should reduce the Company's proposed cost of capital to more closely resemble the proposal of the People, or that of Staff without a liquidity premium (e.g., 9.90%).

B. Cost of Service

1. Operation and Maintenance Expense

Whereas the cost of service should include only the normal, ongoing level of expenses necessary to provide utility service, expenses incurred by NLU in its historic

test year included abnormal and non-recurring costs and certain other items that were not adequately documented. See AG Ex. 1.0 at 7. The Commission should adopt a pro forma operation and maintenance expense of $128,908 after normalizing the actual 2003 operation and maintenance expense for contract services, legal services, rent, regulatory expense and chemical expense. See AG Ex. 1.0, Schedule DJE-2.

NLU charged $24,759 to legal expenses and $231,775 to other contract services in the test year. See AG Ex. 1.0 at 7, and NLU Ex. ISA-2. However, the charges to other contract services included substantial legal fees. Staff Group Cross Ex 1 at 7. Such expenses are both unusual and do not belong in the cost of providing utility service[5]. See AG Ex. 1.0 at 7-8. Removing legal expenses from other contract services and normalizing legal and other contract services leaves a normalized legal expense of $5200 and a normalized contract expense for services other than legal services, of $40,000. See AG Ex. 1.0, Schedule DJE-2. Staff witness Griffin also normalized legal and other contract services to exclude unapproved payments the Company made to affiliated interests. See Staff Ex. 2.0-R at 12-13. The Commission should adopt Mr. Effron's and Mr. Griffin's normalization of legal and contract expenses and reduce the Company's calculations of its operation and maintenance expense by $211,355. See AG Ex. 1.0, Schedule DJE-2.

Both the People and Staff expert witnesses agreed to reduce the Company's chemical expense by the same amount. See Staff Ex. 2.0-R, Schedules 2.08-S and 2.08-

[5] It should be noted that Armstrong testified that the cost of litigation in defending NLU and himself in People of the State of Illinois v. New Landing Utility, Inc. and Gene Armstrong, No. 00-CH-97 (Cir. Ct. Ogle County) amounted to $231, 776. See Staff Group Cross Ex. 1 at 7. He further testified that his contract with Utility Services Company to repair the water tower was for $266,838. See NLU Ex. WTC-F. By spending as much on legal fees as on repair, NLU shows bad judgment and thus its legal fees should not be included in the cost of service.

W and AG Ex. 1.0, Schedule DJE-2. Staff witness Griffin testified that the Company's accounting for chemical expense shows "lumpiness" because it does not use the accrual method for accounting – the industry standard. ICC Staff Ex. 2.0-R at 10. The People agree with Mr. Griffin that NLU should use accrual accounting to smooth out this expense.

Staff and the People also agree that management and rent expenses should be disallowed from operating and maintenance expense because they represent unapproved payments to the Company's affiliates. See Staff Ex. 2.0-R, Schedules 2.11-S, 2.11-W and 2.12-W and AG Ex. 1.0, Schedule DJE-2. The Commission should apply special scrutiny to any of the Company's requests for payments to affiliated interests in light of additional evidence presented in this docket which revealed that NLU has paid the owners and companies in which Mr. Armstrong has an interest, as well as his family members, significant amounts of money, even when other essential utility costs are left unpaid. See generally, Notice of the People of Additional Evidence, Exhibits 1 and 2. The additional evidence prompted Staff Witness Griffin to testify that the Company's cash resources are inappropriately being used to make unapproved affiliate payments while the Company is neglecting to pay for the ordinary, day-to-day upkeep and maintenance of the utility.[6] See ICC Staff Ex. 11.0 at 4-5.

[6] Under current management, NLU allowed the utility to fall into a state of disrepair in violation of the Act and has failed to retain mandatory personnel in violation of Illinois Administrative Code. The Act requires that public utilities must:

furnish, provide, and maintain such service, instrumentalities, equipment, and facilities as shall promote safety, health, comfort, and convenience of patrons, employees and the public, and shall be in all respects adequate, efficient, just and reasonable. See 220 ILCS 5/8-101.

Also, a utility must provide a toll free phone number available 24 hours a day for its customers in the case of emergency situations. See 83 Ill. Adm. Code Section 600.250(a).

The People maintain that the Company's regulatory expense should be normalized to reflect a three-year average, and should recognize the cost of this rate case. See AG Ex. 1.0 at 10. The total regulatory expense allowed for the test year should be $1,551. See id at Schedule DJE-2. The company's calculation for regulatory expense should be rejected because it does not provide a basis. The test year regulatory expense listed by the Company was higher than it was in other recent years. See AG Ex. 1.0 at 10. Therefore, unless the test year is averaged with the two preceding years, an inflated regulatory expense is shown.

For these reasons, the Commission should adopt a pro forma operation and maintenance expense of $128,908 of which $64,899 is for the water utility and $64,010 is for the sewer utility. See AG Ex. 1.0 at 11 and Schedule DJE-2.

2. Depreciation and Amortization

The Commission should adopt Mr. Effron's proposals for the Company's depreciation expense as $9,731 for the water utility and $10,194 for the sewer utility. Mr. Effron's calculations are substantially lower than those of the Company because NLU expensed the depreciation on the contributed portion of the plant, even though contributed plant has no cost to the Company and there is no cost to recover. See AG Ex. 1.0 at 11. The Company does not offset its contributions in aid of construction ("CIAC") against its depreciation expense and therefore arrives at a higher figure for depreciation expense of $35,082. See NLU Ex. ISA-1 and AG Ex. 1.0 at 11. This is erroneous and should be rejected.

3. Income and Other Taxes

Staff Witness Griffin testified that under his alternative schedule contained in Staff Ex. 11.0, he disallowed income taxes because in that scenario, there would be no profit upon which to pay income taxes. See Tr. at 580. The People urge the Commission to adopt Staff's alternative scenario instead of the income tax allowed by Staff Witness Struck in ICC Staff Ex. 1.0-R, Schedules 1.01-S-Rev. and 1.01-W-Rev.

Mr. Armstrong stated to Staff that he did not file tax returns, and Staff found no evidence that taxes were due, or that the Company experienced anything other than losses every year. See Staff Ex. 2.0-R at 11. While Mr. Armstrong testified at the hearing that NLU had recently filed its tax return for all years dating back to 1984, he has not indicated whether the filings resulted in a credit or expense, or whether income s taxes were paid. See Tr. at 580. Further, Mr. Griffin testified at trial that it is possible that the Company would not have to pay income taxes in the future if their tax loss carry-forwards wiped out their tax liability for any given year. Tr. at 581. Based upon the record, the People urge the Commission to find that the Company has not shown that it has an income tax expense and to disallow an income tax expense for NLU.

C. Calculation of Rate Base

The People urge the Commission to adopt Mr. Effron's calculation of the Company's rate base as opposed to the rate base proposed by NLU or Staff. Mr. Effron provides the fairest calculation of rate base, because he began with plant in service as provided by the Company, and then deducted accumulated depreciation to calculate net plant in service. AG Ex. 1.0 at 13 and Schedule DJE-4. Mr. Effron then deducted CIAC and customer advances from net plant in service to arrive at the People's calculation of

rate base. Id. Mr. Effron's calculation is the most fair because he bases his figures on the components of the Company's rate base taken from its Annual Report to the Commission. Id.

The Company's proposal for net rate base is untrustworthy because it is unclear if and where the Company has actually presented a 2003 rate base. See id. Further, Staff witness Griffin testified at trial that in calculating CIAC, the Company's books were wrong. See Tr. at 578. To the extent that the Company's books were incorrect, Mr. Griffin also testified that, because the Company was not keeping continuously proper records, he had to create a utility plant rate base for the Company. See id at 579. Finally, Mr. Griffin testified that to calculate rate base, he took the last Commission Order, found the level of plant, and then added to it known and measurable changes. See id. The Commission's last order with respect to the Company's rate base was over twenty years ago. See AG Ex. 4 at 5. Based upon the record, the People urge the Commission to adopt Mr. Effron's rate base calculation of $476,006.

D. NLU's Revenue Requirement Should Not Be Changed.

Mr. Effron reviewed NLU's revenues, expenses and reasonable rate base. He found that NLU's revenues in fact more than cover its expenses, when the cost of capital is excluded. NLU has admitted that it cannot obtain either debt or equity capital, and did not produce evidence of an existing capital structure which would support a cost of capital expense. Accordingly, the People request that the Commission not change NLU's rates and revenues, and that the $10,000 revenue surplus Mr. Effron identified be set aside for capital improvements.

IV. Conclusion

For the foregoing reasons, the Commission should petition the circuit court in Ogle County to place NLU under the control and responsibility of a receiver and deny NLU's request to increase its revenues, rates and charges..

Respectfully Submitted,

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